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In the Supreme Court of the United States

OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

SHELL OIL COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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v.

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The Solicitor General, on behalf of the Federal Energy Regulatory Commission,[1] petitions for a writ of

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[1] On September 30, 1977, pursuant to the provisions of the Department of Energy Organization Act (DOE Act), Pub. L. 95-91, 91 Stat. 565, and Executive Order No. 12009, 42 Fed. Reg. 46267, the Federal Power Commission ceased to exist. Its functions and regulatory responsibilities were transferred to the Secretary of Energy and to the Federal Energy Regulatory Commission, which, as an independent commission within the Department of Energy, was activated October 1, 1977. Pursuant to Section 402(a)(1)(C) of the DOE Act, "the establishment, review, and enforcement of rates and charges for the transportation and sale of natural gas" in interstate commerce were "transferred to, and vested in" the Federal Energy Regulatory Commission. The "savings provisions" of

certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra*, pp. 1a-10a) is reported at 566 F.2d 536. The order of the Federal Power Commission (No. 539-B) (App. C, *infra*, pp. 13a-32a) is not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on January 20, 1978 (App. B, *infra*). By order of April 11, 1978, Mr. Justice Powell extended the time for filing a petition for a writ of certiorari to May 20, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 52 Stat. 831, as amended, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether the production and gathering exclusion in Section 1(b) of the Natural Gas Act denies the Federal Energy Regulatory Commission authority to require certificated producers of natural gas to "observe the standard of a prudent operator" in developing and maintaining delivery of gas from their dedicated reserves, so as to assure the fulfillment of their duty, under their certificates and Section 7 of the Act, to continue interstate service until the Commission authorizes them to abandon that service.

Section 705 of the DOE Act provide for the substitution of the Federal Energy Regulatory Commission for the Federal Power Commission in pending litigation such as this case.

STATUTES AND REGULATION INVOLVED

Sections 1(b), 7(b), (c), and (e) of the Natural Gas Act, 52 Stat. 821, 824-825, as amended, 15 U.S.C. 717(b), 717f(b), (c), and (e), are set forth as Appendix D, *infra*, pp. 33a-35a.

Section 157.41 of the Commission's Rules and Regulations, 18 C.F.R. 157.41 (1977), provides:

> On and after July 30, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

STATEMENT

A producer seeking to sell natural gas for resale in interstate commerce must first obtain from the Commission under Section 7(c) of the Natural Gas Act, 15 U.S.C. 717f(c), a certificate of public convenience and necessity. The Commission will grant the certificate if it finds "that the applicant is able and willing properly to do the acts and to perform the service proposed" and to conform to the requirements of the

Act and the Commission's rules, and if it further finds that the proposed service "is or will be required by the present or future public convenience and necessity." Section 7(e), 15 U.S.C. 717f(e). The same provision of the Act authorizes the Commission to attach to the certificate "such reasonable terms and conditions as the public convenience and necessity may require." Section 7(e), 15 U.S.C. 717f(e). Once a certificate has been issued, the certificated service is subject to Section 7(b) of the Act, 15 U.S.C. 717f (b), which provides in pertinent part:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission * * * and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

To clarify these requirements and eliminate uncertainty among producers concerning their obligations to maintain deliveries of gas under the Act, the Commission on July 30, 1976, in its Order No. 539-B, adopted the regulation here at issue (18 C.F.R. 157.41 (1977); App. C, *infra*, p. 28a). The regulation provides that on and after July 30, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce are conditioned "to require that the seller shall

observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated [under the certificate]" (*ibid.*). The Commission noted that the standard of a "prudent operator" was well-known in the industry and declared it to mean "the standard of what a reasonably prudent producer would do with respect to the drilling completion, workover, recompletion or abandonment of wells." 41 Fed. Reg. 32884; App. C, *infra*, pp. 19a-20a.[2]

The Commission observed that some parties to its proceeding had advanced the argument "that a common term in producer-pipeline contracts called the 'sole discretion' clause permits the producer complete control over deliverability to the pipeline" (App. C, *infra*, pp. 15a-16a). Rejecting this view, the Commission saw a need "to make clear that its certificate conditions * * * are superior to any limitations on Commission authority contained in the contract," and accordingly to address the question of "what standard

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[2] Order No. 539-B was preceded by a statement of policy, codified as 18 C.F.R. 2.83 (1976), that was promulgated in Order No. 539, issued October 14, 1975. Among other things, this policy would have required seller-producers, as a condition of their certificates, to maintain delivery obligations in accordance with their contracts unless changed by certificate amendment. The Commission concluded, however, that its policy statement should be the subject of a proposed rulemaking and accordingly issued Order No. 539-A, on March 26, 1976, opening such a rulemaking proceeding. The order at issue in this case, No. 539-B, reflects the outcome of that proceeding. It repealed the provisions of 18 C.F.R. 2.83 (1976) that were adopted in the original Order No. 539 (App. C, *infra*, p. 28a).

or test of deliverability the producer is required to live up to under the provisions of the Natural Gas Act and the rules and regulations of this Commission" (*id.* at 16a).

In response to allegations that it lacked authority to enforce certificate obligations by imposing conditions on the certificates, the Commission reasoned that "[s]ince the requirement of service continues until the Commission permits abandonment, and since the holder of a certificate from the Commission must comply with the rules and regulations thereof, [the Commission may act] to preserve the integrity of its certification process by conducting an oversight review of an on-going service obligation" (App. C, *infra*, p. 18a). It further stated that since each certificated contract is subject to the abandonment provisions of Section 7(b) of the Act, "if the seller under a certificate is not meeting the delivery obligations of such certificate, there has been either a partial or total abandonment of certificated service which requires Commission approval pursuant to Section 7(b)" (*id.* at 23a).

Compliance with delivery obligations, the Commission thus reasoned, may be enforced by determining whether the natural gas company has acted prudently in the circumstances. Such a standard, the Commission ruled, is implicit in the service obligation incorporated into all existing certificates under *Sunray Oil Co.* v. *Federal Power Commission*, 364 U.S. 137, 156. The Commission concluded that it should adopt a regulation making this pre-existing "prudent

operator" obligation explicit. It therefore promulgated Section 157.41 of its rules, *supra* (App. C, *infra*, p. 24a).[3]

Respondents, the Shell Oil Company and other producers of natural gas, petitioned for review of Order No. 539-B. The court of appeals vacated and remanded the Order (App. A, *infra*).

The court held that the prudent operator condition was excluded from the Commission's jurisdiction by Section 1(b) of the Natural Gas Act, 15 U.S.C. 717 (b). Section 1(b) provides that the Act "shall not apply * * * to the production or gathering of natural gas." The court reasoned that even though the Commission may enforce service obligations contained in producer certificates by preventing producers from ceasing deliveries from fields capable of continued production, and even though it may regulate abandonments (*id.* at 7a), its jurisdiction does not reach "the physical activities, processes, and facilities of production and development" (*ibid.*). The court found that "Order No. 539-B clearly is intended to open the door to FERC involvement into forbidden production activities" (*id.* at 8a). Declaring that to

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[3] Order No. 539-B indicates that the requirement of Section 157.41 that certificates shall contain an express statement of the prudent operator standard applies to certificates "issued on or after" July 30, 1976 (App. C, *infra*, p. 24a). However, because the Commission believes that the prudent operator standard has been implicit in the requirements of the Act, the principle reflected in Section 157.41 applies to all existing certificates as well, whether or not they contain such an express provision. See App. C, *infra*, pp. 20a-23a.

uphold the order "would all but eliminate the 'production or gathering' exclusion and would allow the FERC to encroach on areas reserved to the states," the court held the order to be beyond the Commission's jurisdiction (*id.* at 9a).

REASONS FOR GRANTING THE WRIT

The court of appeals has held that the Commission lacks jurisdiction to adopt and enforce a standard requiring that certificated producers undertake prudent measures to assure continued delivery of gas they have dedicated to interstate commerce. This erroneous ruling may seriously impair the Commission's ability to carry out its responsibilities under the Natural Gas Act.

1. The Commission's rationale is straightforward. It is well established that the Act and the Commission's jurisdiction extend to producers who sell natural gas for resale in interstate commerce. *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672. It is also well established that a producer (or any other certificated seller) has an obligation under the Act to continue the "service" of delivering gas from his dedicated reserves to interstate commerce until the Commission, under Section 7(b) of the Act, permits abandonment of the service, and that this obligation survives any contract obligation the producer may have. *Sunray Oil Co.* v. *Federal Power Commission*, 364 U.S. 137.

In the Commission's view, these requirements necessarily vest in the Commission some jurisdiction over

the physical acts of the producer and the physical operation of the facilities by which certificated service is rendered. To take a clear case, a certificated producer could not evade his delivery obligations under the Act by deliberately failing to replace a broken washer, or to flush a plugged well-choke, that had stopped the flow of gas from his well. In such an event the Commission's statutory authority and responsibility to enforce its certificates would include the authority to institute a proceeding (see 15 U.S.C. 717s) for enforcement of the producer's certificate obligations, notwithstanding that such enforcement would be based on the producer's physical operation (or non-operation) of his facilities.

The Commission's regulation here has made this principle explicit in order to dispel any uncertainty within the industry. The regulation states and clarifies the relationship between the statutory duty to maintain service under a certificate and the means by which that duty is carried out. The Commission's prudent operator standard is an appropriate formulation of the principle, and the Commission's regulation is an appropriate exercise of its power under Section 7(e) "to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require" (15 U.S.C. 717f(e)).

The prudent operator principle embodied in the regulation is important to the Commission's ability

to carry out its responsibilities under the Act. Many producers today have substantial incentives to cease or reduce their deliveries of natural gas to interstate commerce. Because of the present differential between interstate and intrastate rates for natural gas, and the possibility in the future of some form of deregulation or congressionally mandated increases in interstate prices,[4] producers may rationally prefer to leave their gas in the ground in the hope of better prices in the future. And they may seek to achieve this result by attempting a *de facto* abandonment of certificated interstate service. Since the United States continues to suffer from the shortage of natural gas in the interstate market that was noted by this Court in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, 304, the Commission's authority to prevent such *de facto* abandonment is essential to the performance of its responsibilities under the Act.

2. The court of appeals invalidated the Commission's regulation on the ground that the Commission has no jurisdiction over the producer's physical operation of his facilities, relying for that conclusion on the "production or gathering" exclusion in Section 1(b) of the Act (15 U.S.C. 717(b)). Under the court of appeals' rationale, if a producer in effect

[4] The natural gas provisions of the proposed National Energy Act (H.R. 5289, 8444, 95th Cong., 1st Sess. (1977) now being considered in conference by Congress may contain provisions bearing on the regulatory future of natural gas. The outcome of the legislative discussion, however, is too uncertain to permit meaningful discussion of the proposed legislation as it bears on this case.

abandons a "portion of its facilities" (Section 7(b)) by failing to operate them prudently, the Commission can do nothing to require their continued operation. The Commission can require producers to continue delivery of dedicated reserves under existing certificates only as long as the physical facilities, controlled exclusively by the producers, permit the continued flow of gas. If the producer allows those facilities to fall into disrepair, the Commission is powerless under the court of appeals' ruling to remedy this default, because it involves the physical aspects of the production and gathering process.

That conclusion disregards the purpose and the plain requirements of Section 7 of the Natural Gas Act, as well as this Court's decisions applying the Act to producer transactions. The Court has never held that the production and gathering exclusion in Section 1(b) prohibits administrative action necessary to the achievement of the ultimate purposes of Section 7. Cf. *Permian Basin Area Rate Cases*, 390 U.S. 747, 780. In this case the Commission has found that the achievement of those purposes requires administrative authority over physical operations by producers to the extent necessary to assure that a certificated service in natural gas will be continued until the Commission authorizes its abandonment pursuant to Section 7(b). The Commission's finding is supported by this Court's decisions interpreting Section 7(b). *Sunray Oil Co.* v. *Federal Power Commission, supra*, 364 U.S. at 149-151, 156; *Atlantic Re-*

fining Co. v. *Public Service Commission (CATCO)*, 360 U.S. 378, 389.

As a practical matter, if the Commission lacked such authority producers would be able, through their control of their physical operations, to determine for themselves whether and when to abandon, in whole or in part, the facilities by which they render service. As the Court said in the *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 777. " '[C]onsiderations of feasibility and practicality are certainly germane' to the issues * * *. [The Court] cannot, in these circumstances, conclude that Congress has given authority inadequate to achieve with reasonable effectiveness the purposes for which it has acted." On the contrary, the "Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred; * * *." *Id.* at 776.[5]

[5] The Court has applied the same principle in other contexts. In *United States* v. *Southwestern Cable Co.*, 392 U.S. 157, 178, and *United States* v. *Midwest Video Corp.*, 406 U.S. 649, the Court upheld the jurisdiction of the Federal Communications Commission to impose certain regulations on cable television on the ground that such regulation was "reasonably ancillary to the effective performance of the Commission's various responsibilities for the regulation of television broadcasting" (392 U.S. at 178). Similarly, the Federal Energy Regulatory Commission's jurisdiction over the physical operation of production facilities, to the extent necessary to maintain the producer's delivery obligations, is at least "reasonably ancillary" to the Commission's undisputed jurisdiction under the Act to regulate the sale of natural gas in interstate commerce.

The "production or gathering" exclusion of Section 1(b) requires no different result. As the court of appeals noted (App. A, *infra*, pp. 7a-8a), early cases under the Natural Gas Act indicated that by virtue of this exclusion the Commission had "no control over the drilling and spacing of wells and the like." *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 603; see also *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 509-512. But after this Court held in *Phillips Petroleum Co.* v. *Wisconsin*, *supra*, that the Natural Gas Act applies not only to pipelines but also to gas sales by independent producers for resale in interstate commerce, it began a process of reconciling the production and gathering exclusion with the requirements of Section 7 as applied to sales by producers. Thus, in *Phillips* itself the Court noted that the production and gathering exception to the primary grant of jurisdiction in Section 1(b) was to be strictly construed, and further held that Congress never intended that that exception "would substantially limit the affirmative grant of jurisdiction to the Commission * * *." 347 U.S. at 679.[6]

[6] The Court held (*ibid.*, n. 7):

> The committee reports on the bill enacted as the Natural Gas Act, H.R. 6586, 75th Cong., 1st Sess., reveal that a construction of the "production or gathering" exemption which would substantially limit the affirmative grant of jurisdiction to the Commission was not contemplated. After quoting the exemptive clause of § 1(b), the House Report states that:
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> > "The quoted words are not actually necessary, as the matters specified therein could not be said fairly to

Under *Phillips*, the Commission's jurisdiction embraces interstate sales by producers. Under *Sunray*, *supra*, such sales imply "a continuing obligation to perform 'service' imposed by the Act which outlasts the term of a seller's original contract of sale." 364 U.S. at 153. It follows that the production and gathering exception does not deny to the Commission the authority to assure that the deliverability of dedicated reserves is maintained by prudent physical operation.[7]

The court of appeals' holding to the contrary is inconsistent with its own recognition that the Commission may "enforce 'service obligations' contained in the certificates that it issues to producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production" (App. A, *infra*, p. 7a) (citing *Sunray*), and that the Com-

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be covered by the language affirmatively stating the jurisdiction of the Commission, but similar language was in previous bills, and, rather than invite the contention, however unfounded, that the elimination of the negative language would broaden the scope of the act, the committee has included it in this bill." H.R. Rep. No. 709, 75th Cong., 1st Sess. 3.

The Senate Report adopted and reprinted the House Report on the bill. S. Rep. No. 1162, 75th Cong., 1st Sess.

[7] The Court recognized in *Sunray* (364 U.S. at 156-157) that its holding raised an issue concerning the relationship between the production and gathering exclusion and the service obligation implied in a certificate, but it found that the record did not permit resolution of the issue in that case.

mission may "regulate the 'abandonment of service'" (*ibid.*). More significantly, the holding is inconsistent with this Court's determination of the Commission's responsibilities under Section 7 as set forth in *Phillips* and *Sunray*. The Commission correctly perceived those responsibilities when it held (App. C, *infra*) that under Section 7(b), a seller may not partially or totally abandon its service obligations by failing to undertake reasonable physical measures to maintain delivery of dedicated gas. This "prudent operator" standard is a rule of reason incidental to the duty each producer undertakes when he obtains a certificate to sell his gas for resale in interstate commerce. His "willingness to make the proposed 'sale' * * * must imply willingness to perform the 'service' which it represents." *Sunray*, *supra*, 364 U.S. at 151.[8]

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[8] The court of appeals also suggested, though it did not reach the question, that even if the Commission has jurisdiction to issue such a regulation, the regulation might be invalid because there was no evidence in the record that producers have in fact been withholding their gas from interstate commerce (App. A, *infra*, pp. 2a-3a, n. 1). The suggestion is erroneous. The Commission's regulation does no more than codify, and make applicable to each certificate, an obligation that the Commission believes to be implicit in the Act. The regulation reflects the Commission's interpretation of the statute. The validity of an interpretative rule depends on its consistency with the statute, and not on any factual evidence or factual showing of a need for the rule. See *Abbott Laboratories* v. *Gardner*, 387 U.S. 136, 149; *Gardner* v. *Toilet Goods Association, Inc.*, 387 U.S. 167, 170-171; *Chisholm* v. *Federal Communications Commission*, 538 F. 2d 349, 366

3. Application of the prudent operator standard in particular cases will depend on the circumstances. A spectrum of cases can be posited. At one end is the producer who simply shuts down his well in the hope that higher gas prices will be obtained later, or the producer who deliberately fails to maintain his equipment properly and then claims he is unable to honor his obligation. At the other end may be cases in which production can be maintained only by drilling additional wells or by taking affirmative measures to maintain pressure in the reservoir. In determining what is "prudent," cases of the latter sort may require careful balancing of costs against the service obligation in the light of current regulatory price ceilings.[9]

The application of the prudent operator standard to particular cases, however, is not at issue here. What is at issue is the validity of the principle, appropriately promulgated in a rule, that the Commission has jurisdiction to prevent producers from evading their obligations under the Act by unreasonably failing to operate their facilities in a manner necessary to deliver the gas that they committed themselves to deliver when they obtained a certificate from the Commission. The court of appeals has entered a sweeping invalidation of this principle, on the ground that the production or gathering exclusion deprives the Commission of any authority to reach physical activities. The court has thus rejected not only the explicit provisions of the prudent operator regulation, but also the obligation, held by the Commission to be implicit in all producer certificates, that the holder maintain deliverability by operating prudently.

4. Because the court of appeals' judgment sets aside the Commission's order and regulation, there is no prospect of relitigating the validity of the prudent operator rule on a petition to review it in another circuit. Once the mandate of the court of appeals issues,[10] pending proceedings in other circuits will be mooted because issuance of the mandate will vacate the regulation.[11] Moreover, there is little prospect of testing the Commission's authority by an enforcement action under Section 20 of the Act, 15 U.S.C. 717s, alleging that a producer has violated the prudent operator standard implicit in his certificate. As

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(C.A.D.C.), certiorari denied, 429 U.S. 890. *Superior Oil Co.* v. *Federal Energy Regulatory Commission*, 563 F. 2d 191 (C.A. 5), and the other cases cited by the court of appeals (App. A, *infra*, pp. 2a-3a, n. 1) did not involve interpretative rules; see 563 F.2d 196, n. 9.

[9] See Policy With Respect to Rates Where Reduced Pressures, Need for Reconditioning, Deeper Drilling, or Other Factors Make Further Production Uneconomical at Existing Prices, 18 C.F.R. 2.76 (1977).

[10] The mandate has been stayed pursuant to Fed. R. App. P. 41(b).

[11] Other cases challenging the prudent operator condition have been held in abeyance pending the outcome of the petition for review in the instant case: *The Offshore Co.* v. *Federal Energy Regulatory Commission*, C.A. 5 No. 76-3756; *Continental Oil Co., et al.* v. *Federal Energy Regulatory Commission*, C.A. 5 No. 76-4508; *Cities Service Oil Co.* v. *Federal Energy Regulatory Commisison*, C.A. 5 No. 77-1363; *IGC Production Co.* v. *Federal Energy Regulatory Commision*, C.A. 9 No. 77-1148.

a practical matter, the most likely forum for such a case would be a district court in the Fifth Circuit, from which most of the nation's currently flowing gas comes.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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Federal Energy Regulatory Commission.

MAY 1978.

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 76-3066, Et Al.

SHELL OIL COMPANY ET AL., PETITIONERS

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT

Jan. 20, 1978

Before CLARK, RONEY and TJOFLAT, Circuit Judges:

TJOFLAT, Circuit Judge:

Shell Oil Company and other natural gas producers bring this petition to review the Federal Energy Regulatory Commission's (FERC) Order No. 539-B, —— F.P.C. ——, 41 Fed.Reg. 32,883 (1976), which established a regulation requiring a producer to act as a "prudent operator" in developing and

maintaining deliverability from natural gas reserves.[1]

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[1] Order No. 539-B, —— F.P.C. ——, 41 Fed.Reg. 32,883 (1976), establishes 18 C.F.R. § 157.41 (1977), which provides:

> On and after July [30], 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

Order No. 539-B is the third in a series of FERC orders, dealing with the development and maintenance of natural gas reserves. The first, Order No. 539, —— F.P.C. ——, 40 Fed. Reg. 49,571 (1975), was issued on October 14, 1975, without any notice, comment, or hearing as required for rule-making by the Administrative Procedure Act, 5 U.S.C. § 533 (1970). This Order stated the FERC's intention to enforce "delivery and supply obligations" purportedly contained in producer contracts and producer and pipeline certificates. The FERC's General Policy and Interpretations was amended by this Order by adding a new section, 18 C.F.R. § 2.83 (1975), delineating the FERC's policy on the enforcement of deliverability of natural gas services. On November 28, 1975, the Commission granted reconsideration of Order No. 539 on the application of a number of producers who asserted, among other grounds, that Order No. 539 misinterpreted both the producer-pipeline contractual arrangements and the existing certificate obligations. Issue was also taken with the institution of § 2.83 without following rule-making procedures. Administrative Procedure Act, 5 U.S.C. § 533 (1970). On March 26, 1976, the FERC issued a second order, Order No. 539-A, —— F.P.C. ——, 41 Fed.Reg. 14,531 (1976), to clarify its previous Order and properly to give notice of the intention of the Commission

to promulgate § 2.83 pursuant to a rule-making procedure. Finally, the FERC issued Order No. 539-B, withdrawing § 2.83 and instituting § 157.41, on July 30, 1976.

The impetus behind the FERC's actions was the charge made before various subcommittees of Congress that natural gas producers were avoiding the delivery obligations in their contracts of sale in order to realize greater profits. It was claimed that the producers were diverting natural gas from interstate to intrastate sales or withholding it in hope of future deregulation of the industry. No support for this charge appears in the record before us and the FERC stated in oral argument that its investigation has uncovered no evidence that the natural gas producers have been withholding supplies. We have held that when an FERC order

> originated in a policy decision of the agency and not as the outgrowth of factual determinations, the standard of review is whether the agency's action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (1967). Under that standard we determine "whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Superior Oil Co.* v. *FERC*, 563 F.2d 191, at 201 (5th Cir. 1977).

Section 7(e) of the Natural Gas Act requires the FERC to make findings that a proposed retroactive condition, such as the one imposed by Order No. 539-B, is reasonable and is required by the public convenience and necessity. *Pure Oil Co.* v. *FPC*, 292 F.2d 350, 352-53 (7th Cir. 1961); *see Atlantic Refining Co.* v. *Public Service Comm'n*, 360 U.S. 378, 394, 79 S.Ct. 1246, 1256, 3 L.Ed.2d 1312 (1959) (Harlan, J., concurring) and *Texaco, Inc.* v. *FPC*, 290 F.2d 149, 157 (5th Cir. 1961). In light of the FERC's admission that the natural gas producers were not withholding natural gas from interstate commerce, it is questionable whether Order No. 539-B can survive the limited review explicated in *Superior Oil Co.* We need not reach this question, however, since it will be shown *infra* that Order No. 539-B is beyond the FERC's jurisdiction.

The primary issue before us is whether this Order exceeds the Commission's jurisdiction to regulate the transportation and sale of natural gas in interstate commerce.

The FERC claims that the "prudent operator" obligation is an implied condition of the certificates of public convenience and necessity that are required under the Natural Gas Act before companies may transport or sell natural gas in interstate commerce. The Commission relies upon the concept expressed as "service" in the Natural Gas Act[2] to establish its

[2] Natural gas companies perform a service to the public, and the Commission's authority extends to ensuring that the service is properly performed even if it is not specifically manifested in a contractual relationship. *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960). This service is derived from the section of the Natural Gas Act empowering the FERC to issue certificates:

> . . . [a] certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. 15 U.S.C. § 717f(e) (1970).

authority to hold certificate recipients to the "prudent operator" standard. No separate statutory or regulatory grant of jurisdiction has been cited by the FERC.

The producers, however, argue that the FERC is prohibited from issuing Order No. 539-B by the specific exclusion of "the production and gathering of natural gas" from the Commission's jurisdiction and that the FERC cannot use the power to issue certificates to extend its jurisdiction into the excluded area.[3] We agree with the producers and vacate the FERC's Order.

The jurisdiction of the FERC to regulate the natural gas industry is delineated by § 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b) (1970):

> The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

The producers are subject to the jurisdiction of the FERC when they engage in activities that can be

[3] Natural Gas Act § 1(b), 15 U.S.C. § 717(b) (1977). This was the position taken by Commissioner Watts in his dissent from Order No. 539-B.

classified as sales or transportation rather than as production or gathering. *Phillips Petroleum Co.* v. *State of Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954). Through the years, the "production or gathering of natural gas" exemption has been judicially narrowed. The progression can be seen by comparing *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949) with *United Gas Improvement Co.* v. *Continental Oil Co.* (*Rayne Field*), 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965). The *Panhandle* case held that gas leases relate to the production or gathering of natural gas and are thus outside the jurisdiction of the FERC. The Supreme Court narrowly construed *Panhandle* in *Rayne Field* when it held that leases that are in essence sales of the gas reserves are within the FERC's jurisdiction. In *Rayne Field* the producers recast a conventional wellhead purchase of natural gas as a purchase of the leasehold interests in the natural gas field. The Supreme Court described this sale of leasehold interests as "very close in economic effect to [traditional] sales of natural gas," *id.*, 85 S.Ct. at 1520, and stated that:

> *The "production or gathering" exemption relates to the physical activities, processes and facilities of production or gathering*, but not to sales of the kind affirmatively subjected to Commission jurisdiction. This accommodation of the two relevant clauses of § 1(b) gives content to the national objectives of the Natural Gas Act as expanded in Phillips, and to the Commission's jurisdiction to accomplish them, while in no way

> interfering with state regulatory power over the physical processes of production or gathering in furtherance of conservation or other legitimate state concerns. *Id.* 381 U.S. at 403, 85 S.Ct. at 1523. (Emphasis added.)

The FERC can enforce "service obligations" contained in the certificates that it issues to producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production. This doctrine was developed in *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 80 S.Ct. 1392, 4 L.Ed. 2d 1623 (1960) and *Sun Oil Co.* v. *FPC*, 364 U.S. 170, 80 S.Ct. 1388, 4 L.Ed.2d 1639 (1960), based on the power to issue certificates, see note 2 *supra*, and prevents producers from beginning delivery to another party after the initial contracts expire. Another line of cases permits the FERC to regulate the "abandonment of service." *Mitchell Energy Corp.* v. *FPC*, 533 F.2d 258 (5th Cir. 1976); *Panhandle Eastern Pipe Line Co.* v. *Michigan Consolidated Gas Co.*, 177 F.2d 942 (6th Cir. 1949).

No case has been found, however, that extends FERC jurisdiction directly into the physical activities, processes, and facilities of production and development. The cases recognizing the broad scope of the FERC's authority have nonetheless also recognized the "production or gathering" exclusion. In *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 65 S.Ct. 829, 89 L.Ed. 1206 (1945), after holding that the FERC could include production properties in the rate base of an interstate pipeline company, the Supreme Court stated:

> that does not mean that the part of § 1(b) which provides that the Act shall not apply "to the production or gathering of natural gas" is given no meaning. Certainly that provision precludes the Commission from any control over the activity of producing or gathering natural gas. For example, it makes plain that the Commission has no control over the drilling and spacing of wells and the like. *Id.* at 602-03, 65 S.Ct. at 839.

In *Continental Casualty Co.* v. *Associated Pipe & Supply Co.*, 447 F.2d 1041, 1052 (5th Cir. 1971), we echoed Mr. Justice Blacks' definition of "the production or gathering of natural gas:"

> "Production" of gas [means] the act of bringing gas from the earth, and "gathering" [means] the act of collecting gas after it has been brought forth. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 518, 69 S.Ct. at 1262 (Black, J., dissenting).

See also Northern Natural Gas Co. v. *State Corporation Comm'n*, 372 U.S. 84, 90, 83 S.Ct. 646, 650, 9 L.Ed.2d 601 (1963) (" 'production' and 'gathering' are terms narrowly confined to the physical acts of drawing the gas from the earth and preparing it for the first stages of distribution.")

Order No. 539-B clearly is intended to open the door to FERC involvement into forbidden production activities:[4]

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[4] During oral argument, the FERC's counsel first stated that the FPC could require producers to drill new wells pursuant to Order No. 539-B; counsel later withdrew from this position and stated that the Commission could not do so because such a requirement would be beyond its power. The Commission staff, however, has not adopted a restrictive view of the authority granted to the FERC under Order 539-B. In its initial brief to the FERC in Docket No. R175-112 (Dec. 6, 1976), the Staff stated:

> Immediate development of these known proved reserves will serve the public interest by increasing the supply of natural gas available to the interstate market. In the event that such development is not undertaken voluntarily by the producers, *staff recommends that the Commission use its authority pursuant to Order 539-B to insure full and timely development of these dedicated proved reserves.*
>
> An answer to the question of whether *production from "behind the pipe" reserves should be accelerated by drilling new wells* involves a policy determination based on a careful consideration of a number of factors . . . *Id.* at 213. (Emphasis added.)

> This [prudent operator] standard encompasses the obligations to develop the properties consistent with the performance requirements of lease agreements with mineral owners and/or assignors; all valid rules and regulations of any Federal, state or local government having jurisdiction; and the *standard of what a reasonably prudent producer would do with respect to the drilling completion, workover, recompletion or abandonment of wells.* —— F.P.C. at ——, 41 Fed.Reg. at 32,884. (Emphasis added.) (Footnote omitted.)

To hold that the power to issue Order No. 539-B is within the jurisdiction of the FERC would all but eliminate the "production or gathering" exclusion and would allow the FERC to encroach on areas reserved to the states.[5] We cannot so extend the au-

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[5] The Supreme Court has discussed extensively the legislative history of the Natural Gas Act in *Phillips Petroleum*

thority of the Commission.[6]

VACATED AND REMANDED.

Co. v. *Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954) and *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949). *See also Panhandle Eastern Pipe Line Co.* v. *Public Service Comm'n of Indiana*, 332 U.S. 507, 514-21, 68 S.Ct. 190, 193-97, 92 L.Ed. 128 (1947); *Interstate Natural Gas Co.* v. *FPC*, 331 U.S. 682, 689-90, 67 S.Ct. 1482, 1486-87, 91 L.Ed. 1742 (1947); *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 601-03, 65 S.Ct. 829, 838-39, 89 L.Ed. 1206 (1945); *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 609-13, 64 S.Ct. 281, 291-92, 88 L.Ed. 333 (1944); *Illinois Natural Gas Co.* v. *Central Illinois Public Service Co.*, 314 U.S. 498, 506-08, 62 S.Ct. 384, 397-98, 86 L.Ed. 371 (1942). It is clear that the Natural Gas Act was passed to fill the gap in regulation of the natural gas industry created by judicial holdings precluding state regulation of interstate commerce:

> The Natural Gas Act was designed to supplement state power and to produce a harmonious and comprehensive regulation of the industry. Neither state nor federal regulatory body was to encroach upon the jurisdiction of the other. Congress enacted this Act after full consideration of the problems of production and distribution. It considered the state interests as well as national interests. *Panhandle Eastern Pipe Line Co.*, 337 U.S. at 513, 69 S.Ct. at 1260. (Footnotes omitted.)

[6] One final question raised concerns the "prudent operator" standard promulgated by Order No. 539-B. The argument is advanced that the "prudent operator" standard is inappropriate to FERC's goal to increase production of natural gas because "prudent operator" is a term of art employed in state regulations which are concerned with increasing the total recovery of hydrocarbons through the *conservation* of natural gas fields rather than permitting operators to waste energy resources by *exploitation* of reserves. We do not reach the issue due to our disposition on jurisdictional grounds.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1977

No. 76-3066, et al.

FPC No. RM 76-8

SHELL OIL COMPANY, ET AL., PETITIONERS,

versus

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

Petitions for Review of an Order of the
Federal Power Commission

Before CLARK, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

This cause came on to be heard on the petitions of Shell Oil Company, et al. for review of an order of

the Federal Power Commission, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the order of the Federal Power Commission in this cause be, and the same is hereby vacated; and that this cause be, and the same is hereby remanded to the Federal Power Commission in accordance with the opinion of this Court;

It is further ordered that intervenor-respondent, Consumer Federation of America, pay to intervenors-petitioners, the costs on appeal to be taxed by the Clerk of this Court.

January 20, 1978

APPENDIX C

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; Don S. Smith, John H. Holloman III, and James G. Watt.

Docket No. RM76-8

POLICY WITH RESPECT TO ENFORCEMENT OF DELIVERABILITY AND RENDITION OF NATURAL GAS SERVICE UNDER CERTIFICATED ARRANGEMENTS

ORDER NO. 539-B

ORDER CLARIFYING PRIOR ORDERS AND AMENDING SECTION 157 OF THE COMMISSION'S REGULATIONS UNDER THE NATURAL GAS ACT

(Issued July 30, 1976)

In Order No. 539 [1] the Commission reiterated its policy to enforce certificated delivery obligations. In Order No. 539-A [2] the Commission clarified its prior

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[1] Promulgating Statement of Policy, Order No. 539, Docket No. RM76-8, —— FPC —— (October 14, 1975).

[2] Order Granting In Part And Denying In Part Reconsideration, Clarifying Order No. 539, Denying Stay, Noticing Of Proposed Rulemaking, Noticing Of Oral Argument And Granting Intervention, Order No. 539-A, —— FPC —— (March 26, 1976).

order, granted in part and denied in part reconsideration, and issued a notice of proposed rulemaking to promulgate Section 2.83 as a section of the Commission's General Policy and Interpretations. Written comments on the proposed rulemaking were received and oral argument before the Commission was held on May 4, 1976. The entire record in Docket No. RM76-8 is now before us for final determination.

In Order No. 539, we spoke of a "certificated minimum daily delivery obligation". From the reactions of the parties, we learned that the quoted phrase meant different things to different persons, depending, of course, on their respective views of the certainty of natural gas production. Some respondents interpreted the phrase to mean that a producer would be required to deliver a set volume of gas every day for the entire contract term or be subject to the criminal penalties of the Natural Gas Act,[3] while other persons related the meaning of the phrase to the producer's best efforts to deliver presently producible supplies. Our attempt in Order No. 539-A to clarify the meaning of "certificated minimum daily delivery obligation" did not settle the matter, as the continued confusion in the rulemaking proceeding showed. We must conclude that the clause is not one that has a generally accepted meaning among pipelines and producers. In this order, based on all material submitted in Docket No. RM76-8, we will make clear the intention of the Commission with respect to

[3] Natural Gas Act, § 21; 15 U.S.C. § 717t.

its policy on certificate obligations and enforcement of such obligations.

Under Section 7 of the Natural Gas Act,[4] the Commission authorizes a natural gas company to perform a service, the sale for resale in interstate commerce of natural gas. In order for this sale by a producer to be lawful, it must procure from the Commission a certificate of public convenience and necessity. This certificate is the physical evidence of the producer's right to commence the approved service.[5] The certificate itself sets forth the terms and conditions under which the producer must operate, which include but are not limited to those obligations incurred by reason of the contract of sale.

Whatever the obligations voluntarily entered into by the producer in the contract of sale with the pipeline, the contract terms must normally bow to the conditions included in the certificate. Where, however, the contract provisions incorporated into the certificate include greater responsibilities and obligations than those imposed by the certificates, such as in a warranty of delivery agreement, the producer, of course, will be held accountable to those greater responsibilities and obligations.

Some parties to this proceeding advance the argument that a common term in producer-pipeline contracts called the "sole discretion" clause permits the

[4] Natural Gas Act, § 7; 15 U.S.C. §§ 717f(a)-(e).

[5] *Atlantic Refining Co.* v. *Public Service Commission of N.Y.*, 360 U.S. 378, 389 (1959).

producer complete control over deliverability to the pipeline. Thus, a typical reservations clause in a sales contract provides, in part, that the seller reserves the right "to operate its property free from any control by Buyer in such manner as Seller, in its *sole discretion* may deem advisable, including without limitation, the right to drill new wells, to repair and rework wells and to abandon any well. . ." [6] (Emphasis added.) Even though the view that the seller rules the transaction is not universally held even in the industry,[7] the Commission wants to make clear that its certificate conditions, and the incidents of service which it represents, are superior to any limitations on Commission authority contained in the contract.

The question then, which the Commission attempted to address in Order Nos. 539 and 539-A, is what standard or test of deliverability the producer is required to live up to under the provisions of the Natural Gas Act and the rules and regulations of this Commission. Natural gas companies,[8] as that term is defined in the Natural Gas Act [9] are required

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[6] See, *e.g.*, Comments of Tenneco Oil Company, Docket No. RM76-8, Appendix A, p. 7, filed April 19, 1976.

[7] Oral Argument, Tr. 95-96.

[8] The Supreme Court's decision in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1974) found independent producers to be "natural gas companies" within the meaning of Section 2(6) of the Natural Gas Act, 15 U.S.C. 717a(6).

[9] 15 U.S.C. § 717a.

under Sections 4, 5, and 7 [10] to fulfill certain service obligations arising from the Act itself,[11] together with other responsibilities that may result from other Federal or State laws or the law of private contracts. Pursuant to the Act itself, however, jurisdictional sales, service, and operation of natural gas companies must be just, reasonable, not unduly discriminatory, preferential, or otherwise unlawful, and in the public interest.

In response to the allegations that have been made concerning our authority to enforce certificate obligations and to condition certificates to aid in this enforcement, Section 7(e) of the Natural Gas Act [12] provides that, in order for the Commission to issue a certificate of public convenience and necessity, it must determine that the applicant is ". . . able and willing *properly* to . . . perform the service proposed . . ." (emphasis added). Certain parties to this proceeding have asserted that this finding is made only at the commencement of the sale. Such a contention does not comport with the ordinary meaning of "service", which implies a continuing obligation, nor with the remainder of the section, which requires that the applicant be found to be willing to conform to the provisions of the Natural Gas Act and the Commis-

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[10] 15 U.S.C. §§ 717c, 717d, 717f.

[11] *F.P.C.* v. *Louisiana Power and Light Company*, 406 U.S. 621 (1972); *Pennsylvania Water and Power Company* v. *F.P.C.*, 343 U.S. 414, 422 (1952).

[12] 15 U.S.C. § 717f(c).

sion's Regulations.[13] The Commission has long recognized a distinction between the service to the public that is certificated and the contractual agreement that provides for the sale, especially since the service obligation outlives the contractual authorization.[14] Since the requirement of service continues until the Commission permits abandonment, and since the holder of a certificate from the Commission must comply with the rules and regulations thereof, it is simply incorrect to assert that the Commission cannot act to preserve the integrity of its certification process by conducting an oversight review of an on-going service obligation.[15] A mere reference to the authority granted the Commission in Section 5(a) of the Act[16] should suffice to prove the correctness of the view that the Commission has a continuing responsibility to the public to insure that recipients of certificates issued by the Commission are, throughout the life of the certificate, performing consistent with their obligations under the Natural Gas Act.

Historically, jurisdictional actions of natural gas companies have been reviewed by this Commission on the basis, among others, of whether the company

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[13] *Mitchell Energy Co.* v. *F.P.C.*, —— F.2d ——, No. 75-3110 (5th Cir., June 11, 1976).

[14] *Sunray Mid-Continent Oil Co.* v. *F.P.C.*, 364 U.S. 137 (1960) at 152-153.

[15] *United Gas Pipe Line Co.* v. *F.P.C.*, 385 U.S. 83, 89 (1966).

[16] 5 U.S.C. § 717d.

acted prudently under the circumstances presented.[17] The prudent operator standard has long been established as an implied covenant in lease agreements, which means that producers are very familiar with the requirements of this standard.[18] Furthermore, state regulatory agencies, whose principal purpose is conservation of natural resources, require producers to conform to their codified regulations, which are consistent with the responsibilities imposed by the prudent operator standard.[19] The Department of the Interior has, in effect, incorporated the prudent operator test into its offshore regulations by the use of the terms "reasonable" and "diligence" in describing the lessee's obligations as set forth in the leasing agreement.[20] Obviously, then, all producers are acquainted with the strictures of the prudent operator standard. Therefore, there should be no contention that the Commission's action in the instant order is insufficiently specific for respondents to understand the responsibilities incurred in complying with the prudent operator standard.[21]

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[17] *F.P.C.* v. *Natural Gas Pipeline Company*, 315 U.S. 575 (1942).

[18] *See*, Williams, Howard R. and Meyers, Charles J., *Oil and Gas Law*, § 806, Prudent-Operator Standard, Volume 5, Matthew Bender & Company, Inc. (1972). *See also*, Oral Argument of May 4, 1976, in Docket No. RM76-8, Tr. 6-7, 62-64, 95-96, 122; *Gas and Oil*, § 127 Generally; prudent operator rule, 38 Am. Jur.2d 601 (1968).

[19] Oral Argument, Tr. 15.

[20] 30 C.F.R. § 250.33, 43 C.F.R. §§ 3307.3-2, 3307.3-4.

[21] Our clarification herein should not be interpreted as relieving pipelines from their obligations, arising under the

Once deliveries have commenced under the certificate, as conditioned, the responsibility for the development and maintenance of the gas reserves underlying the committed acreage rests with the producer, and the applicable standard by which to judge whether a producer is properly proceeding with these responsibilities will be the above-referenced "prudent operator standard".

This standard encompasses the obligations to develop the properties consistent with the performance requirements of lease agreements with mineral owners and/or assignors; all valid rules and regulations of any Federal,[22] state or local government having jurisdiction; and the standard of what a reasonably prudent producer would do with respect to the drilling completion, workover, recompletion or abandonment of wells.

We have set forth in this order the nature and extent of the service obligations incurred by a natural gas company in accepting a certificate from this Commission, along with tracing the historical link between service and prudent operation. Therefore, it is consistent with the expression in Order Nos. 539 and 539-A of a statement of policy, that the Commission reiterates its intention to enforce the prudent operator standard as implicit in the service obligations contained in all existing certificates.

Natural Gas Act, to enforce certificated contractual obligations unilaterally where the need arises.

[22] Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331, *et seq. See also,* 30 C.F.R. §§ 250, *et seq.*; 43 C.F.R. §§ 3300, *et seq.; OCS Orders 1 through 12, Governing Oil, Gas, And Sulphur Leases To The Outer Continental Shelf Gulf Of Mexico Area,* United States Department of the Interior, Geological Survey, Conservation Division, January, 1975.

The Commission's authority to hold certificate recipients to the prudent operator standard rests, as we have previously stated, in the concept expressed in the Natural Gas Act as service, as that term has been interpreted by the Commission and the courts. For example, the Supreme Court in *Sunray Mid-Continent Oil Company* v. *Federal Power Commission* [23] stated:

> [t]he Commission's practice supports its authority here in the terms of § 7(e). It has long drawn a distinction between the underlying service to the public a natural gas company performs and the specific manifestation—the contractual relationship—which that service takes at a given moment.[24]

The Commission has embodied this idea into its certificates of public convenience and necessity by including as a condition thereof the following language:

> The grant of the certificates issued in paragraph (A) above shall not be construed as a waiver of the requirements of Section 7 of the Natural Gas Act or of Part 154 or Part 157 of the Commission's Regulations thereunder and is without prejudice to any findings or orders which have been or which may hereafter be made by the Commission in any proceedings now pending

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[23] 364 U.S. 137 (1960).

[24] *Id.* at 152.

or here instituted by or against Applicants. Further, our action in this proceeding shall not foreclose or prejudice any future proceedings or objections relating to the operation of any price or related provisions in the gas purchase contracts herein involved. The grant of the certificates aforesaid for service to the particular customers involved does not imply approval of all of the terms of the contracts, particularly as to the cessation of the service upon termination of said contracts as provided by Section 7(b) of the Natural Gas Act. The grant of the certificates aforesaid shall not be construed to preclude the imposition of any sanctions pursuant to the provisions of the Natural Gas Act for the unauthorized commencement of any sales of natural gas subject to said certificates.[25]

The Commission has only recently spoken to the issue presented in this rulemaking procedure, the relationship of the contract to the certificate and which prevails if there is a conflict. In its Opinion No. 662 the Commission held that:

> [t]he contract between Texas Eastern and Gulf obviously gave rise to rights and obligations; much is made in the briefs before us concerning the nature, extent and enforceability of those rights and obligations. We set these matters aside. We look instead to Gulf's certificate of public convenience and necessity, for it too gave rights and obligations, and these are clearly ours

[25] *See, e.g.*, Amoco Production Company, et al., Docket No. CI63-479, *et al.*, issued September 19, 1975.

> to interpret, modify, or enforce as the case may require. (Footnote omitted.)[26]

As an additional objection to a Commission imposed standard of deliverability, the producers have strenuously argued that Section 1(b) of the Natural Gas Act prohibits the Commission from conditioning, pursuant to Section 7(e) of the Act, a certificate to aid in the enforcement of delivery obligations that exist in a contract as certificated. Section 1(b) does not, however, preclude the Commission from enforcing the contractual provisions of a gas sales contract and various delivery obligations contained therein or in the certificate. As the Court indicated in *Phillips Petroleum Company* v. *Wisconsin*,[27] "sales in interstate commerce for resale by producers to interstate pipeline companies do not come within the 'production or gathering' exemption." Once a contract has been certificated, the obligations must be performed in accordance with the provisions of the Natural Gas Act, including Section 7(b) of the Act. If the seller under a certificate is not meeting the delivery obligations of such certificate, there has been either a partial or total abandonment of certificated service which requires Commission approval pursuant to Section 7(b). Accordingly, attachment of a condition to a certificate to assure compliance with Section 7(b) of the Act cannot be considered an unreasonable condi-

[26] *Gulf Oil Corporation*, Docket No. CI64-26, 51 FPC 1340, 1352 (1974).

[27] 347 U.S. 672, 680-81 (1954).

tion contrary to the requirements of Section 7(e) of the Act. Moreover, Section 1(b) of the Act does not, in any fashion, limit the Commission's authority conferred upon it by Section 7(b).

Despite the Commission's belief that the prudent operator standard is implicit in the service obligation included in all certificates issued by this Commission, we wish to make this point clear to all future certificate applicants by including as a condition in all certificates issued on or after the date of this order notice of the supremacy of the certificate to the contract and the application of the prudent operator standard to deliverability obligations. Therefore, pursuant to the notice of proposed rulemaking set forth in Order No. 539-A, the Commission will amend its Rules and Regulations to add a new Section 157.41, to read as follows:

> On and after July 30, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

A party that objects to the inclusion of this condition in its certificate may reject the certificate outright

or accept with the reservation of its right to appeal the offending condition under Section 19(b).[28]

In light of our clarification of Order Nos. 539 and 539-A holding a producer to the legally applicable principle of the prudent operator standard, Section 2.83 of the Commission's Regulations is hereby deleted from the Commission's General Policy and Interpretations. As to all certificates issued from October 14, 1975 to date that contain Section 2.83(d) as a condition thereof, whether accepted and/or whether rehearing or reconsideration of the order issuing said certificate was sought or not, the Section 2.83(d) condition contained therein is hereby vacated, but each and every other condition included in said certificate is fully applicable, unless such condition has become the subject of a petition for rehearing or reconsideration that has been granted by this Commission.

In lieu of the Section 2.83(d) condition included in all certificates issued on or after the October 14, 1975 date of Order No. 539, the Commission will substitute therefore the prudent operator standard presented herein and incorporated into the Commission's Regulations as new Section 157.41. This provision applies whether rehearing or reconsideration was sought, whether granted as yet or not, those proceedings are incorporated into this rulemaking proceeding for resolution. Because of the Commission's decision expressed in this order to use the prudent operator

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[28] 15 U.S.C. § 717r.

test to judge the service obligation of the producer under the certificate, all petitions for rehearing or reconsideration pending before this Commission are granted in part and denied in part.

Finally, the data necessary to facilitate any Commission action deemed necessary in implementing the instant order is either currently required to be filed by the appropriate persons or will be required as a result of our order implementing Form No. 108. More specifically, any information and materials submitted by virtue of Form No. 108, Form No. 15 and Form No. 40 will be used to assist the Commission and its Staff in enforcing certificated obligations.

The Commission finds:

(1) The Commission's prior orders, Order Nos. 539 and 539-A, should be clarified consistent with this order.

(2) The notice and opportunity to participate in this proceeding with respect to the matter presently before the Commission through the submission, in writing of comments and through participation at oral argument before the Commission, is consistent and in accordance with all procedural requirements therefore as prescribed in Section 553, Title 5 of the United States Code.

(3) The amendment to Section 157 of the Commission's Regulations Under the Natural Gas Act is necessary and appropriate for the administration of the Natural Gas Act.

(4) Section 2.83 should be deleted from Part 2, Statements of General Policy and Interpretations of the Commission.

(5) The Commission should include in all certificates issued on or after the date of issuance of this order a condition stating that all sales made pursuant to the certificate are subject to review under the prudent operator standard.

(6) It is in the public interest to delete Section 2.83 (d) as a condition to all certificates issued on or after October 14, 1975, whether such certificates were accepted or not, and insert in its place the condition set forth in the newly promulgated Section 157.41 of the Commission's Regulations under the Natural Gas Act.

(7) It is in the public interest that all petitions for rehearing or reconsideration raising an issue regarding the imposition of Section 2.83(d) as a condition to a certificate are incorporated into this proceeding for disposition of that issue and should be granted in part and denied in part for the reasons expressed in this order.

The Commission orders:

(A) The Commission's Order Nos. 539 and 539-A are clarified consistent with this Order.

(B) The Commission, acting pursuant to its authority under the Natural Gas Act, as amended, particularly Sections 4, 5, 7, and 16 thereof, 15 U.S.C. 717c, 717d, 717f, and 717o, hereby orders that its General Rules, Title 18 of the Code of Federal

Regulations, be amended by adding a new Section 157.41 as follows:

> On and after July —, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

(C) Section 2.83 is deleted from Part 2 Statements of General Policy and Interpretations of the Commission.

(D) The Section 2.83(d) condition attached to all certificates issued on or after October 14, 1975, is deleted from such certificates and the condition contained in Section 157.41 of the Commission's Regulations under the Natural Gas Act is inserted in its place.

(E) All petitions for rehearing or reconsideration raising an issue regarding the imposition of Section 2.83(d) or as a condition to a certificate of public convenience and necessity are incorporated into this proceeding for disposition of that issue and are granted in part and denied in part for the reasons expressed in this order.

By the Commission. Commissioner Watt, dissenting, filed a separate statement appended hereto.

[SEAL]

KENNETH F. PLUMB,
Secretary.

WATT, Commissioner, *dissenting*:

I have worked hard with my fellow Commissioners in an effort to resolve our differences in this case. Unfortunately, there is one major issue we have not been able to agree upon. Therefore I must dissent.

Order No. 539 from its inception has been a nightmare for the Federal Power Commission. That Order states, "The Commission has concluded that it should formally reiterate its policy with respect to the enforcement of the requirements of the Natural Gas Act . . ." because ". . . Questions concerning deliverability and supply obligations of natural gas producers and natural gas pipelines have arisen in connection with numerous Congressional hearings involving the Natural Gas Act." The Order proceeds then to outline what at the time was thought by a few to be the Federal Power Commission policy.

The Order has brought confusion and misunderstandings because many have interpreted it to be an unauthorized extension of jurisdiction not conferred by the Natural Gas Act. As a result of that October 1975 Order, access to over 18 Bcf of natural gas is being denied to the interstate market. In addition, there could well be a substantial quantity of natural gas that has not been considered for introduction into the interstate market because of fears created by the illegal extensions of authorities assumed by the Federal Power Commission.

Once the Commission paused to look at what had been done in the original Order, Order No. 539-A was

issued in an attempt to clarify and straighten out the errors. In my opinion, the rewriting of the policy statement in Order No. 539-A was correctly and properly done. But unfortunately, the majority insisted upon maintaining the § 2.83(d) condition in all certificates. The majority now has recognized that error and in Order 539-B has withdrawn and expunged from all those certificates the ill-conceived language. (I have consistently dissented to the inclusion of the § 2.83(d) language in all certificates.)

Now the majority in an attempt to again clarify and straighten out the problems that continue to multiply, has issued a new Order that in my judgment is, also, in error. It creates a substitute condition (Section 157.41) for all certificates that dictates action which is beyond FPC authority.

In my opinion, the Federal Power Commission authority, conferred by the Natural Gas Act with respect to producers, is limited virtually to rate regulation.[1] The Federal Power Commission does not have the authority to require the development of gas reserves dedicated to the interstate market. That authority rests in the lessor or appropriate governmental agency specifically granted such authority by enabling legislation.

A possible result of today's Order is that additional gas will be lost to the interstate market while pro-

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[1] See e.g. *Interstate Natural Gas Co.* v. *F.P.C.*; 331 U.S. 682, 690, 691 (1946) and *Colorado Interstate Gas Co.* v. *F.P.C.*; 324 U.S. 581, 597-604 (1946).

ducers seek judicial remedy of the errors of the Federal Power Commission. It is unfortunate that the Commission continues to insist upon asserting jurisdiction over activities over which it has no authority.

/s/ James G. Watt
Commissioner

APPENDIX D

Section 1(b) of the Natural Gas Act, 52 Stat. 821, 15 U.S.C. 717(b) provides:

> (b) Transactions to which provisions of chapter applicable
>
> The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Section 7(b) of the Natural Gas Act, 52 Stat. 824, 15 U.S.C. 717f(b) provides:

> (b) Abandonment of facilities or services; approval of Commission
>
> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

Section 7(c) of the Natural Gas Act, as added, 56 Stat. 83, 15 U.S.C. 717f(c) provides in pertinent part:

> (c) Certificate of public convenience and necessity
>
> No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: * * *
>
> * * * *

Section 7(e) of the Natural Gas Act, as added, 56 Stat. 84, 15 U.S.C. 717f(e) provides:

> (e) Granting of certificate of public convenience and necessity
>
> Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and

> that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

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